
Middle East Instability Drives Crude Oil Prices

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The availability of relatively cheap crude oil is an important variable in the growth of developed and developing economies. As a result, the US Department of Energy indicated that crude oil is the lifeblood of the US economy. The price of crude oil, however, has increased significantly from \$35.00 in 2000 to more than \$72.00 in 2006. Prices began to increase around the fourth quarter of 2003, subsequent to the preemptive strike on Iraq. Higher prices mean that consumers use more of their disposable income to pay for products and services derived from crude oil. Therefore, higher prices are akin to a tax on consumers.

Many politicians and pundits attribute higher prices to increased demand, shortages, or supply manipulations by energy companies. Demand, however, has not increased significantly and crude oil is plentiful. British Petroleum (BP) Statistical Review of World Energy June 2005, documented that in 2000 worldwide crude oil production was 74,950 million barrels per day and increased to 80,260 million barrels per day in 2004, or a 7 percent increase in 5 years. According to the Energy Information Administration (March 2006, International Petroleum Monthly), average total world demand in 2005 was 83.62 million barrels per day and average total world supply was 84.08 million barrels per day. The Economist (Aug. 13, 2005) also indicated that crude is plentiful, and this is expected due to the

lure of higher prices. Furthermore, supply manipulation by refiners would have significantly curtailed refinery output. However, the Annual Energy Review 2004 documented increases in refinery output, in spite of industry consolidation.

The three leading world petroleum consumers are the United States, Japan, and China. US' consumption in 1990 was about 18 million barrels per day and rose to about 21 million barrels per day in 2005; Japan's consumption in 1990 was 5.2 million barrels per day and was approximately 5.4 million barrels per day in 2004. China's consumption in 1990 was approximately 2.5 million barrels per day and about 7 million barrels per day in 2005. US and Japan's consumption remained almost constant between 1990 and 2004, at about 5 and 20 million barrels per day, respectively.

So, what is driving up the price of crude oil? The main reason for the increase is instability in the Middle East. Instability causes traders to bid up future prices and provides refiners with the opportunity to charge as much as the market can bear. And, hints of preemptive strikes on Iran create further market instability and heighten the belief of future crude oil shortages. Perceived future shortages means that the future price of a barrel of crude oil will continue to increase.

Under perceived market instability, the ability to increase margins (raise prices) does not require output reduction (shortage), higher demand, or supply manipulation; it merely requires consumers to believe that a shortage, or pent up demand, exist. Additionally, industry consolidation from 319 operable

refineries in 1980 to 149 in 2004 facilitates the psychological perception of shortages and hence margin increases.

The ability of refiners to increase margins is reflected in industry press releases. For example, ExxonMobil's Chairman Rex Tillerson noted in their April 27, 2006 release of their first quarter results, "Higher crude oil and natural gas realizations and improved marketing margins were partly offset by lower chemical margins." And, Chevron's CEO, Dave O'Reilly, in their first quarter (2006) news release noted "Prices for crude oil and natural gas were strong during the period..." In the refiners' lingo, *higher crude oils and gas realizations* (Exxon's) and *strong prices* (Chevron's) imply that they were able to raise prices to obtain higher profits margins. These signals and significantly higher energy companies' profit margins lead consumers to believe that price gouging is occurring.

Higher crude oil prices will, more likely than not, lead to a worldwide economic slump. Economic studies (Hamilton, 1983) have shown secular, as well as a cyclical, correlation between energy and output. For instance, Hamilton noted that OPEC's increases in 1974:1 caused output reduction in 1975:1; gasoline shortages and price increases due to the Iranian revolution in 1979:2 preceded the business cycle peak of 1980:1; and increases due to the Iran-Iraq war 1980:4-1981:1 caused the business cycle peak of 1981:3. Thus, crude oil price increases due to the Iraq invasion are likely to adversely affect the world economy.

How can the administration mitigate crude oil price increases? In the absence

of alternate sources of energy, the administration should remedy the root cause of the increases, which is the war in Iraq and Middle East tensions. In the long run, however, the US must invest in research to create alternate clean energy sources and establish robust energy conservation goals. The cost of the Iraq adventure could have been invested in energy research, education and health care. Finally, politicians should understand that choice wars often have unintended consequences.

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